Veterans Memorial Plaza
Indianapolis, Indiana

The DFI Update

Summer 2003 Edition

August 2003

Periodic Publication of the Indiana Department of Financial Institutions

Inside this issue:

Review of External Audit Policy Underway

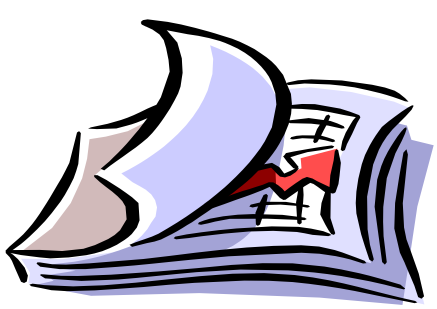
Section 28-13-10-8 of the Indiana Code requires each financial institution or holding company to have an annual external audit. The provisions of this statute are supplemented by Department Policy, which became effective on July 1, 1992. The policy statement provides for two alternative types of audits, the "full scope audit' and the "restricted scope balance sheet only audit". Other significant provisions of the policy statement includes specifications for the management letter, timeliness for submission of the audit report, required peer reviews for audit firms, and written notification to the Department when an external auditor is dismissed or resigns. Additionally, the board of directors must establish an audit policy addressing internal and external audit programs. The required audit policy must be reviewed annually as to its ongoing appropriateness.

The passage of the Sarbanes-Oxley Act of 2002 addressing, among other things, auditing standards and corporate governance applicable to publicly traded companies and federal interagency guidance dealing with the same issues triggered the Department's review of external audit policy requirements. The length of time that the policy had been in place also influenced the decision to initiate a thorough review of the policy. Many of the standards addressed in Sarbanes-Oxley apply (through federal law) to financial institutions with assets of $500 million or more even if they are not publicly traded. Three relevant documents have been issued by the federal banking agencies: FDIC guidance on corporate governance "best practices" (3/5/03), Interagency Policy on the internal audit function and its outsourcing (3/17/03), and additional interagency guidance on corporate governance (5/5/03). Sarbanes-Oxley was clearly not intended to apply to non-public institutions; however, there continues to be ongoing uncertainty as to how financial institutions not publicly traded with assets of less than $500 million are to approach the referenced issues. More specifically, the areas of auditor independence and corporate governance have not been definitively clarified for those not subject to Sarbanes-Oxley or applicable federal banking law.

The Department to date has met with several accounting firms that perform external audits for DFI supervised institutions. We have sought input from these firms on a myriad of issues dealing with auditor independence, corporate governance, and the appropriateness of continuing to authorize restricted scope balance sheets audits for the purpose of complying with external audit policy requirements. Department representatives have also met with the Indiana Bankers Association and the Community Bankers Association of Indiana executives to inform them of our endeavors and to seek their input. Most recently, letters were sent to the 19 institutions that continue to utilize the restricted scope audit seeking input as to the merits of continuing to authorize this type of external audit format.

The current goal for formulating a draft, if necessary, of a revised external audit policy is fall of 2003. The policy draft, if and when completed, will be distributed to all interested and affected parties for review and input.

Should you have thoughts on comments regarding the appropriateness of the current external audit policy or proposed revisions, please contact this Department via our website www.in.gov/dfi, by phone 317/232-3955, or in writing at Department of Financial Institutions, 30 South Meridian Street, Suite 300, Indianapolis, Indiana 46204.



Recently Passed Legislation

House Bill 1834

Indiana Code 28-1-20-4 was amended to prohibit non-banks from using the word "banc" or "banco", in addition to "bank", as part of its name. It also prohibits non-banks from using the name, or a name confusingly similar to that, of an existing bank or bank holding company when marketing to or soliciting business without the consent of the bank or bank holding company.

Article 6.1 and Article 15 were amended to extend federal law pertaining to affiliates to savings banks and savings associations, respectively. These amendments impose the provisions of Sections 23A and 23B of the Federal Reserve Act to the same extent and in the same manner as if these institutions were a member of the Federal Reserve System.

Chapter 4 of Article 11 was amended to strengthen and expand the ability of the Director of the Department to permanently remove officers, directors, and employees from a financial institution. It also prohibits an officer, director, or employee who is removed from a position under a removal order from the Director to participate in the conduct of the affairs of any financial institution without the approval of the Director.

A new provision was added to IC 28-13-4-5. This provision requires a corporation to obtain the approval of the Department before reducing its capital stock, capital surplus, or preferred stock.

House Bill 1653

In addition to several clarifying amendments, this bill amended IC 28-13-9-2 to allow the Director to waive the United States citizenship requirement for a director of a corporation provided the waiver would affect only a minority of the total number of directors of the corporation.

Copies of both of these bills can be found on the Department's website at www.in.gov/dfi.

Debt Cancellation by Depository Institutions Questions and Answers

1. Can a state chartered depository institution offer debt cancellation agreements on their loan agreements?

Yes. The DFI believes that a state chartered depository institution can offer debt cancellation agreements on direct loans as an incidental power under IC 28-1-1-3.1 for banks and IC 28-7-1-9 for credit unions.

2. What steps should a state chartered depository institution take if they wish to offer debt cancellation agreements?

If a depository institution offers debt cancellation, then it is expected that the institution will notify the DFI to ensure that any safety and soundness issues have been addressed. The department would look to 12 CFR Part 7 and 37 as issued by the OCC for National banks for guidance on compliance for state chartered depository institutions. These guidelines became effective June 16, 2003. NCUA authorized debt cancellation for federal credit unions under 12 CFR 721.2 in 2001 with further guidelines in May of 2003. OTS authorized debt cancellation in 1995 if the cost was included in the finance charge.

3. Would a depository institution that wishes to offer debt cancellation agreements be required to purchase a third party contractual liability policy to cover any losses?

...continued next page

The DFI would evaluate any debt cancellation program that is submitted to the department by a depository institution. However, if the depository institution obtains a contractual liability policy, issued by an Indiana Department of Insurance approved carrier, then safety and soundness concerns are more adequately addressed. The depository institution using a third party administrator for claims processing can further address these types of issues.

4. Can a depository institution include the cost of debt cancellation in the disclosed finance charge on consumer loans?

If, on consumer purpose loans, the depository institution includes the debt cancellation in the cost of credit as part of the basic finance charge or as a "prepaid" finance charge that is collected at the closing of the loan (deducted from the amount financed and reflected in the total disclosed finance charge and Annual Percentage Rate (APR), then the institution would just have to meet safety and soundness concerns and ensure that the total finance charge does not exceed statutory maximums under IC 24-4.5-3-508.

5. What if the depository institution wants to <u>exclude</u> the debt cancellation charge from the disclosed finance charge and assess it as an "additional charge" under IC 24-4.5-3-202(1)(e)?

If a depository institution offers debt cancellation on consumer purpose loans other than first lien mortgages and they want to exclude the cost of this coverage from the finance charge, then it must be approved as an additional charge under the above referenced provisions of the IUCCC. First lien mortgages (purchase money or refinance) are covered only by contractual and disclosure requirements under IC 24-4.5-3-105 and 3-301.

6. What does IC 24-4.5-3-202(1)(e) require for a charge to be a permitted exclusion from the finance charge?

The creditor/third party administrator must submit a written explanation of the charge to the department indicating how the charge would be assessed and the value or benefit to the debtor. The department may require supporting documents. The 7 Member Board of the department shall determine whether the charge would be of benefit to the debtor and is reasonable in relation to the benefits. This information would be submitted in addition to any safety and soundness concerns.

Please contact Mark Tarpey of the Consumer Credit Division at the Department for additional guidance concerning the above. See the DFI policy statement at www. in.gov/dfi/policies.

December 31, 2002 Financials

The number of state-chartered commercial banks, stock and mutual savings banks, and active industrial authorities remained constant at 129 throughout the calendar year of 2002. National banks in Indiana decreased from 33 to 30 during the same period. Total state chartered supervised assets increased during the 2002 calendar year from $39.2 billion to $42.2 billion. This increase is due to the stability and growth of the existing state chartered financial institutions. National bank assets decreased slightly from $76.2 billion to $73.9 billion in the calendar year 2002. As of December 31, 2001, state-chartered commercial banks represented 36.3% of total Indiana bank assets (state and national). In contrast, state-chartered commercial banks represented 81% of the total number of such banks in the state of Indiana.

During 2002, two financial institutions converted from national or federal charter to state chartered commercial banks. Two state bank charters were eliminated through mergers with other state or national banks.

Both state and national banks have had very stable performance over the last five years. The sustained profitability measure is attributed to strong loan growth and maintenance of sound credit quality. The net income for state-chartered financial institutions over the past five years is $298 million in 1998, $284 million in 1999, $285 million in 2000, $442 million in 2001, and $473 million in 2002. Net income as a percentage of assets (in the aggregate) for the calendar year 2002 increased slightly to 1.18% from 1.17% at year-end 2001. In 1998, state chartered commercial banks had an aggregate ROA and five year high of 1.25%. The net income for national banks in Indiana over the past five years starting with 1998 is $632 million, $730 million, $413 million $740 million and $1,075 million respectively. The aggregate ROA for national banks over the same period has ranged from 1.58% in 1998, to a high of 1.85% in 1999, to a low of 0.80% in 2000, to its current level of 1.74%. The significant decrease in net income for national banks during the calendar year 2000 is attributed to large charge offs due to business restructuring by one of the larger national institutions.

The allowance for loan and lease losses and net charge offs for state banks have remained consistent over the last five years. The aggregate allowance for loan and lease losses for Indiana state chartered banks reached a five year high of 1.41% in 2002 from 1.37% as of year-end 1998 and a low of 1.26% in 2000. The aggregate allowance for loan and lease losses for national banks in Indiana ranges from 1.39% in 1998, to a high of 1.65% in 1999, and a low of 0.79% in 2002. Net charge offs for state banks for the 2002 calendar year increased to 0.40% compared to 0.21% in 1998. Net charge offs for national banks ranged from 0.38% in 1998 to 0.66% for calendar year 2001 to 0.32% in 2002.

Income Statement

ACCOUNT DESCRIPTIONS	State	National	State	National
(IN MILLIONS OF $)	12/31/2002	12/31/2002	12/31/2001	12/31/2001
Number of Banks	129	30	129	33
Consolidated Income Statement				
Total Interest Income	2,397	3,737	2,681	4,537
Total Interest Expense	939	1,223	1,344	2,079
Net Interest Income	1,458	2,513	1,337	2,458
Total Non Interest Income	683	1,290	638	1,722
Loan Provisions	175	202	127	406
Total Non Interest Expense	1,291	1,988	1,200	2,681
Net Income	473	1,075	442	740
Ratio Analysis				
Net Income to Average Assets	1.18%	1.74%	1.17%	1.14%
Net Income to Year End Total Equity	10.77%	18.25%	11.16%	11.83%
Net Interest Income to Average Assets	3.65%	4.08%	3.55%	3.79%
Total Loans to Total Deposits	92.54%	192.10%	86.40%	135.25%
Loan Loss Provisions to Total Loans	0.63%	0.35%	0.51%	0.75%
Loan Loss Reserves to Total Loans	1.41%	0.79%	1.31%	1.27%
Net Charge-Offs to Total Loans	0.40%	0.32%	0.35%	0.66%
Total Equity Capital to Total Assets	10.41%	7.97%	10.11%	8.21%
Total Equity Capital and Reserves to Total Assets and Reserves	11.24%	8.53%	10.86%	9.03%

...continued next page

Total equity capital for Indiana state chartered banks has increased from $2.33 billion as of December 31, 1998, to $4.39 billion as of December 31, 2002 or a 88.41% increase. Total equity capital for national banks in Indiana has increased from $4.24 billion in 1998 to $5.89 billion as of year-end 2002 or a 38.92% increase. The ratio of total equity capital to total assets has increased from 9.16% to 10.41% for state chartered institutions from year-end 1998 to year-end 2002. The ratio of total equity capital to total assets for national banks over the same period has ranged from 8.68% in 1998 to a high of 9.29% in 1999 and a low of 7.97% in 2002.

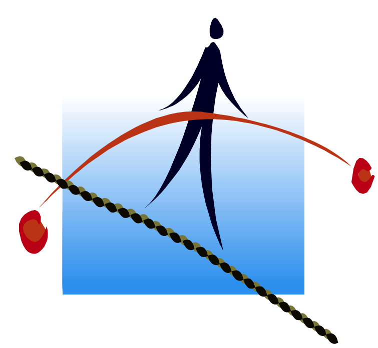
The ratio of loans to deposits has continued to increase over the last five years for both Indiana state chartered banks and national banks. Total loans for state banks have gradually increased from $16.9 billion in 1998 to $28.0 billion in 2002 or a 65.7% increase. In contrast, total deposits for state banks increased from $20.4 billion to $30.2 billion in 2002 or a 48%. Total loans for national banks in Indiana have increased from $34.3 billion in 1997 to $57.2 billion as of December 31, 2002. Total deposits for national banks decreased from $34.9 billion as of December 31, 1998 to $29.8 billion as of December 31, 2002.

The ratio of total deposits to total liabilities by both the state and national banks in Indiana have decreased over the past five years as banks continue to increase there reliance on wholesale funding. The ratio for state banks deposits to liabilities decreased from 88.55% in 1998 to 79.92% in 2002. In contrast, the ratio for national banks in Indiana decreased each year from 78.13% as of December 31, 1998, to 43.79% as of December 31, 2002.

The trend analysis utilized the following consolidated balance sheet, consolidated income statement and ratio analysis for all state chartered commercial banks, savings banks, active industrial authorities and national commercial banks. Information to compile these schedules was obtained through the Federal Deposit Insurance Corporation's Database.

Balance Sheet

ACCOUNT DESCRIPTIONS	State	National	State	National
(IN MILLIONS OF $)	12/31/2002	12/31/2002	12/31/2001	12/31/2001
Number of Banks	129	30	129	33
Consolidated Balance Sheet				
Trading Accounts	13	2	105	331
Interest Bearing Balances	375	770	264	437
Fed Funds Sold/Repurchase Agreements	0	0	2,165	1,667
Total Securities	8,561	8,613	8,598	11,702
Total Loans	27,959	57,166	24,910	54,038
Total Earning Assets	36,908	66,551	35,953	68,175
Total Assets	42,198	73,853	39,175	76,154
Average Assets	39,938	61,637	37,661	64,927
Total Deposits	30,212	29,759	28,831	39,954
Total Liabilities	37,803	67,962	35,212	69,835
Total Equity Capital	4,392	5,889	3,962	6,254
Loan Valuation Reserves	395	451	327	686
Total Equity Capital & Reserves	4,787	6,340	4,289	6,940
Total Other Real Estate	41	146	29	90
Total Charge-Offs	142	227	110	418
Total Recoveries	29	43	22	61
Net Charge-Offs	113	184	88	357



Employee Spotlight

...introductions, congratulations & departures...

Please extend a warm welcome to...

Matt Dilly is a May 2002 graduate of Hanover College. He earned a B.S. in Business Administration. Matt joined the Department on January 6, 2003. He resides in Seymour, Indiana and is assigned to District II of the Bank and Trust Division as a field examiner.

Tabitha Gran joined the DFI on June 9, 2003. She lives in Mishawaka and is assigned to the Consumer Credit Division as a field examiner. Tabitha graduated in May of 2003 from Ball State with a degree in accounting.

Nathan Riley is a May 2001 graduate of Western Kentucky University. He earned a B.S. in Business Economics.. Nathan joined the Department on March 18, 2003. He resides in Indianapolis, Indiana and is assigned to District I of the Bank and Trust Division as a field examiner.

David Sandidge is a May 2003 graduate of Butler University. He earned a B.S. in Finance. David joined the Department on June 9, 2003. He resides in Vevay, Indiana and is assigned to District II of the Bank and Trust Division as a field examiner.

Collin Shipman joined the DFI on June 9, 2003. He resides in Brownsburg and is assigned to the Consumer Credit Division as a field examiner. Colin graduated from IU in Bloomington in May of 2003 with a degree in Public Finance.

Kevin Vaughn is a May 2003 graduate of the Purdue University Krannert School of Management. He earned a B.S. in Management, Finance. He joined the Department on June 9, 2003. He resides in Lafayette, Indiana and is assigned to District I of the Bank and Trust Division as a field examiner

Kyra Wagoner is a May 2003 Cum Laude graduate of Butler University. She earned a B.S. in Business Administration, Finance and Journalism. Kyra joined the Department on June 9, 2003. She resides in Greenwood, Indiana and is assigned to District I of the Bank and Trust Division as a field examiner.

We would like to introduce you to our new Board Members...

David Bochnowski joined the DFI Board in September 2002. Currently, he is the Chairman and CEO of Northwest Indiana Bancorp. He is immediate past chairman of America's Community Bankers. He also serves as Trustee of the Indiana Banker's Association Medical Insurance Trust and is active in the formation of a city-wide Community Development Corporation for Gary, Indiana.

Michael Davis joined the DFI Board in September 2002. With 32 years of experience in finance, Mr. Davis is a retired Acquisitions Analyst from the General Motors Acceptance Corporation. He served in the U.S. Airforce in the United States, Thailand, and England and has an extensive educational background.

Congratulations to...

John Schroeder of the Administration Division graduated from Indiana University Law School in May 2003.

Renita Stubbs of the Administration Division was promoted to an Administrative Assistant in October 2002.

Barb Cole of the Bank Division was promoted to an Administrative Assistant in January 2003.

Congratulations to…

(continued)

Chris Dietz assigned to District I of the Bank Division received certification as a Certified Operations Examiner in June 2003.

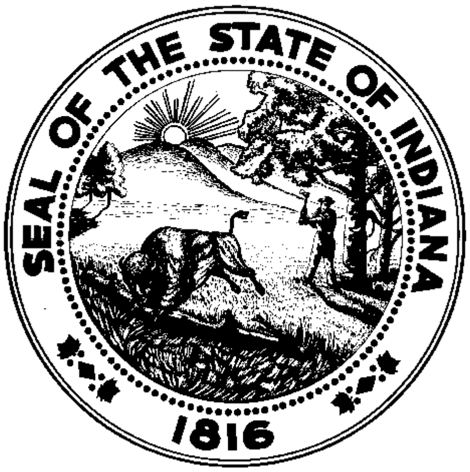
Cort Schreiber, son of **Kirk Schreiber,** Senior Analyst of the Bank Division, competed for the second consecutive year at the U.S. Diving Junior Nationals in Coral Springs, Florida. Cort is 14 years old and finished 17th in the nation for boys 14 to 15 years old in platform diving.

Way to go Cort!

Farewell and Best Wishes to...

James M. Saner, Sr.—his term as a member of the Department of Financial Institutions expired on June 30, 2003. James continues to serve as President and CEO of Mainsource Financial Group, Inc.

Tracy Baker, Administrative Assistant in the Bank Division, departed in December 2002. Tracy accepted a position with the Indianapolis City Government.



State of Indiana
Department of Financial Institutions

30 South Meridian Street, Suite 300
Indianapolis, Indiana 46204

Phone: 317/232-3955
Fax: 317/232-7655

or e-mail us:

Bank and Trust Division
Jcooper@dfi.state.in.us
Rrowe@dfi.state.in.us

or

Consumer Credit Division
Pgoddard@dfi.state.in.us
Mtarpey@dfi.state.in.us

our web address is:
www.in.gov/dfi

Mission Statement

To regulate and supervise Indiana State chartered commercial banks, trust companies, savings banks, savings and loan associations, credit unions, pawnbrokers, money transmitters, industrial loan and investment companies, budget service companies, rental purchase businesses, check cashers, and licensees under the Uniform Consumer Credit Code in a manner that:

- *Assures the residents of Indiana adequate and proper financial services,*
- *Protects the interests of depositors, borrowers, shareholders and consumers, and*
- *Promotes safety and soundness in Indiana State financial institutions.*